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No. 94-1796

In the Supreme Court of the United States

OCTOBER TERM, 1995

ALBERTSON'S, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioner is entitled to current deductions for annual increases, which it characterizes as "interest," in its obligations to make future payments to selected executives under deferred compensation agreements that do not otherwise qualify for immediate deductions under the Internal Revenue Code, even though the executives concerned report no income under those agreements until the years in which payments are actually received.

2. Whether the "sole justification" for petitioner's installation of heating, ventilating, and air conditioning systems in its retail grocery stores was to provide the temperature and humidity necessary to operate refrigerated food cases, so that the cost of those systems qualified for the tax credit formerly available for investments in certain personal property.

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OPINIONS BELOW

The initial opinion of the court of appeals (Pet. App. 20a-40a) is reported at 38 F.3d 1046. That court's opinion on rehearing of the deferred compensation issue (Pet. App. 1a-19a) is reported at 42 F.3d 537. The opinion of the United States Tax Court on the deferred compensation issue (Pet. App. 41a-69a) is reported at 95 T.C. 415. That court's memorandum opinion on the investment tax credit issue (Pet. App.

70a-81a) is reported unofficially at 56 T.C. Memo. (CCH) 928.[1]

JURISDICTION

The judgment of the court of appeals was originally entered on December 30, 1993. That court's judgment on rehearing of the deferred compensation issue was entered on December 5, 1994. Further petitions for rehearing were denied on February 2, 1995. Pet. App. 92a. The petition for a writ of certiorari was filed on May 1, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case involves deficiencies in petitioner's federal income taxes for petitioner's taxable year ending February 3, 1983. During that year petitioner operated more than 400 retail food and drug stores throughout the western, southern, and southeastern United States. See Pet. App. 21a n.1.

1. a. Beginning no later than 1974, petitioner entered into "deferred compensation" agreements with eight of its senior executives and one outside director. Pet. App. 2a, 27a. Under the agreements, the employees elected to defer payment and receipt of part of their yearly salary, bonuses, or director's fees until they retired or otherwise terminated their employment with petitioner (and thereafter, at each participant's option, for up to fifteen additional years). *Id.* at 2a-3a. At the end of the deferral period the

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[1] The court of appeals also affirmed (Pet. App. 22a-26a) the Tax Court's decision that petitioner was not entitled to certain work incentive credits. That decision (*id.* at 82a-91a) is reported informally at 59 T.C. Memo. (CCH) 186. Petitioner does not seek review of the work incentive credit issue.

participants were entitled to receive the amounts originally deferred, in a lump sum or periodically, plus "a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest." *Id.* at 3a n.1, 27a n.9. The "rate of interest" used was either petitioner's average long term borrowing rate for the appropriate year, or a published rate for certificates of deposit over $1 million. *Id.* at 2a-3a & n.1, 27a & n.9; Stip. of Facts, Exhs. 4-D through 12-L.

Petitioner did not fund (through present contributions to a trust, escrow account, or similar arrangement) any portion of its contractual obligation to make future payments under the deferred compensation agreements. The obligation was an unsecured promise, reflected only in bookkeeping entries. Pet. App. 42a-43a. Since 1960, the Internal Revenue Service has permitted employees who enter into such agreements before rendering services, and who otherwise compute their income and tax liability on the basis of cash receipts and disbursements, to defer recognition of any income until the years that payments under the agreement are actually received. Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 70-435, 1970-2 C.B. 100.

Petitioner is an accrual-basis taxpayer (Pet. App. 21a n.1). Before 1983, petitioner claimed no deductions, either for amounts that participants elected to defer or for any "further sum[s] of money" to be paid eventually under the agreements, unless payments were actually made to a participant during the year. Pet. App. 45a. For the taxable year at issue, however, petitioner contended for the first time that the "further sum[s] of money" accrued on its books, but

not paid out, under the agreements constituted "interest * * * on indebtedness" that was currently deductible under Section 163 of the Internal Revenue Code, 26 U.S.C. 163 (1988 & Supp. V 1993). Pet. App. 45a. The Commissioner of Internal Revenue disallowed the deduction, *id.* at 46a, and petitioner sought review of that determination in the United States Tax Court.[2]

b. The full Tax Court upheld the Commissioner's position. Pet. App. 41a-60a. The nine-judge majority concluded that the amounts petitioner sought to deduct were not "interest" on "indebtedness" for purposes of Section 163. Pet. App. 48a-53a. Because participants entered into deferred compensation

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[2] In 1982, petitioner requested permission "to change its method of accounting for interest accrued on deferred compensation from the cash basis to the accrual basis." Stip. of Facts, Exh. 18-R, App. A; see Pet. 4. The IRS's letter granting that permission, which focused largely on the accounting mechanics of the change, made clear that "[t]he taxpayer['s] belie[f]" that the amounts in question "should be characterized as interest" was "a material representation upon which [the] letter [was] issued." Stip. of Facts, Exh. 20-T, at 1. The letter granted permission to deduct any interest expense "as it [was] properly incurred" (*id.* at 2), and explicitly stated that the letter "should not be construed as a determination as to the proper timing for the accrual of interest expense on deferred compensation or to its characterization as a liability to the taxpayer" (*id.* at 3). The IRS later issued a technical advice memorandum which concluded that the amounts petitioner had designated as "interest" were instead "compensation for personal services rendered" and, accordingly, revoked its approval of the change in accounting method. Stip. of Facts ¶ 41. Petitioner expressly abandoned below any argument that the Commissioner's decision to revoke the prior permission and to disallow the deductions at issue here was impermissibly "retroactive." Pet. App. 46a-47a.

agreements before performing the services for which the compensation was rendered. they never had a legal right to demand payment of that compensation in the year they rendered the services. Because they did not receive payment, either actually or constructively, they were not required to report the compensation as income for that year. Correspondingly, however, "[p]etitioner could not have 'borrowed' something from the * * * participants that the * * * participants never had the right to possess." *Id.* at 50a. Thus, additional amounts computed and eventually to be paid under the terms of the agreements were not "interest" on "indebtedness," but rather "an integral part of the method used by petitioner to calculate the total amount of deferred compensation to be paid" under those agreements. *Id.* at 53a.

Four concurring judges agreed that petitioner was not entitled to a current deduction, but preferred not to rest their analysis on whether the additional amounts at issue represented "interest" on money constructively "borrowed" from employees who entered into deferred compensation agreements. Pet. App. 61a-63a. The concurrence focused instead on Section 404 of the Code, "the plain purpose of [which] is to require matching of income inclusion and deduction as between the employee and employer" in such arrangements. Pet. App. 62a. The opinion concluded that, even if the time-value component of a deferred compensation payment were to be labelled as "interest," "allow[ing] an accrual method employer to deduct interest in advance of inclusion by employees

would frustrate the matching principle apparent in the statute." *Id.* at 63a.[3]

Five judges dissented, concluding that the amounts at issue were deductible as interest under Section 163, without limitation by Section 404. Pet. App. 64a-69a.

c. The court of appeals at first "reluctantly" reversed. Pet. App. 27a-37a; *id.* at 29a. The court concluded that the "additional amounts" specified in the deferred compensation agreements represented a fair measure of the time value of money, and therefore qualified as "interest" for purposes of Section 163 of the Code. Pet. App. 29a-32a. Although sympathetic to the argument that Congress intended the timing restrictions of Section 404 to apply to all payments under a deferred compensation plan (Pet. App. 37a; see also *id.* at 4a-5a), the court concluded (*id.* at 32a-37a) that the language of Section 404 did not prohibit the current deduction of accrued amounts that were properly characterized as "interest" for purposes of Section 163.

The same panel of the court of appeals subsequently granted the government's petition for rehearing, vacated its earlier opinion, and affirmed the Tax Court's decision. Pet. App. 1a-19a. On rehearing, the court declined to reach the question whether the additional amounts payable under petitioner's deferred compensation agreements should be characterized as "interest." See *id.* at 4a-5a, 19a. Instead, the court focused on Section 404's principle of "ensur[ing] matching of income inclusion and

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[3] Judge Hamblen indicated agreement with both the majority and concurring opinions. Pet. App. 60a, 63a. Judge Whalen did not participate in the decision. *Id.* at 60a.

deduction between employee and employer" under deferred compensation schemes like petitioner's. Pet. App. 11a; see *id.* at 11a-18a. The court concluded that "[w]hether or not the additional amounts constituted interest" (*id.* at 19a), allowing the deductions sought by petitioner would "contravene the clear purpose of the taxation scheme Congress created to govern deferred compensation plans" (*id.* at 8a). In particular, it would undercut the statutory incentives that Congress created to encourage employers to create "qualified" deferred compensation plans (which must generally be broadly available to the sponsor's employees, pre-funded, and administered through a special trust), by providing similar or even greater incentives to create "nonqualified" arrangements like petitioner's deferred compensation agreements with a few of its highly compensated executives. See *id.* at 8a-10a, 12a-15a. The court therefore rejected petitioner's argument that Section 404 authorized deduction of the additional amounts before they were actually paid out under the agreements in question. Pet. App. 19a.

2. On audit of its return for the 1982-1983 tax year, petitioner claimed the investment tax credit (ITC), formerly available under Section 38 of the Code (see Pet. App. 93a-95a), with respect to heating, ventilating, and air conditioning (HVAC) systems that it had installed in 33 of its stores. See Pet. App. 38a, 76a. Under the applicable Treasury Department regulation, HVAC systems were generally considered "structural components" of the buildings in which they were installed, and therefore did not qualify for the ITC. Treas. Reg. § 1.48-1(e) (1982) (*reprinted at* Pet. App. 97a-99a). Under the same regulation, however, HVAC systems could qualify for the ITC

under an exception applicable to "machinery the sole justification for the installation of which" was that it was "required to meet temperature or humidity requirements which [were] essential for the operation of other machinery." Treas. Reg. § 1.48-1(e)(2) (1982) (Pet. App. 98a).

Petitioner claimed that it was entitled to the ITC because its "sole justification" for installing the HVAC systems was meeting the temperature and humidity requirements for its refrigerated food display cases and computerized checkout equipment. Pet. App. 38a. The Commissioner disallowed the claimed credits, and petitioner sought review in the Tax Court.

The Tax Court found that the HVAC systems in petitioner's stores maintained the temperature and humidity conditions appropriate for the proper functioning of open-front refrigerated food display cases. Pet. App. 81a; see *id.* at 71a-74a. Finding the existence of an HVAC system "crucial" to the operation of petitioner's stores, and any benefits related to customer comfort merely "incidental," the court concluded that those systems met the "sole justification" test of the regulations. *Id.* at 81a.

The court of appeals reversed. Pet. App. 37a-40a. The court pointed out that petitioner's HVAC systems "play[ed] an important role in ventilating its supermarkets," thus keeping them clean, pleasant, and safe. *Id.* at 38a-39a. Moreover, in the court's view, air conditioning and heating "clearly provide[d] a comfortable shopping environment for [petitioner's] customers" in stores located from Florida to Idaho. *Id.* at 39a. Indeed, the court noted that petitioner "had already installed HVAC systems in most of its supermarkets [during the 1950s], well before it was

aware of any interrelationship between HVAC systems and the proper functioning of its other equipment." *Ibid.* Under those circumstances, the court concluded that the Tax Court had committed "clear error" in finding that petitioner's HVAC systems satisfied the "sole justification" test. *Id.* at 39a-40a.

ARGUMENT

1. Petitioner contends (Pet. 12-13, 15-23) that the court of appeals erred in rejecting petitioner's attempt to take current deductions for deferred compensation payments that will not be made, or included in its employees' income, for years to come. The court's decision is correct, and the matter does not warrant further review.

a. Before 1942, employers using the accrual basis of accounting could generally accrue deferred compensation and deduct it, as an "ordinary and necessary business expense," in the year in which the obligation to make a particular payment first arose. See Pet. App. 55a. Most employees, by contrast, compute income on the basis of cash receipts and disbursements. Thus, by entering into a properly structured deferred compensation agreement with an employee, an accrual-basis employer could receive immediate deductions without any current cash outlay, while the employee could receive a vested right to future payments without reporting any current income. See *id.* at 10a. This asymmetry in tax accounting led to "considerable abuse." *Id.* at 55a-56a.

To address this situation, Congress amended what is now Section 404 of the Internal Revenue Code. Under Section 404 (and related provisions), employers

and employees may achieve the dual advantages of current deductibility and deferred inclusion only by maintaining a so-called "qualified" deferred compensation plan. Among other requirements, such a plan must not discriminate in favor of highly compensated individuals; the employer must generally make contributions in trust for the sole benefit of plan participants (thus placing the funds beyond the control of the employer in the year of contribution and deduction); and the employer's contributions must generally meet certain minimum standards in relation to the benefits promised under the plan. If a plan meets all the requirements for "qualification," then the employer receives a current deduction for amounts contributed to the trust, the trust itself is exempt from tax, and employee participants are not taxed, either on the employer's contributions or on the trust's earnings, until they actually receive benefits paid by the trust under the plan. See generally 26 U.S.C. 401(a), 402(a), 404, and 501(a) (1988 & Supp. V 1993); 2 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 60.1, at 60-2 (2d ed. 1990) (hereafter Bittker & Lokken).

An employer may enter into a deferred compensation agreement with any of its employees without complying with the nondiscrimination, trust, funding, or other conditions necessary to create a "qualified" plan. Since 1942, the Code has provided that when an employer incurs an obligation for future payment under such a "nonqualified" arrangement, it is not entitled to a deduction until the year in which an equivalent amount is includible in the income of the employee concerned. See Pet. App. 10a-11a, 56a; 26 U.S.C. 404(a)(5) and (b). The year of inclusion for a cash-basis employee is determined under principles of

actual or "constructive" receipt. Under longstanding practice, if an employee agrees in advance to defer compensation for services to be rendered in the future, the employee generally will not be treated as having constructively received the compensation so deferred until payment is actually made. See, *e.g.*, Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 70-435, 1970-2 C.B. 100; *Martin* v. *Commissioner*, 96 T.C. 814 (1991); *Commissioner* v. *Oates*, 207 F.2d 711 (7th Cir. 1953); Bittker & Lokken ¶ 60.2.1, at 60-4.

b. As the Tax Court correctly recognized (Pet. App. 48a-53a), against this background, the "further sum[s] of money" provided for in petitioner's deferred compensation agreements (see *id.* at 3a n.1) are not properly viewed as "interest * * * on indebtedness" that is deductible under Section 163(a) of the Code. We do not dispute that those amounts are intended to reflect the time value of money. See Pet. App. 30a-31a. While all interest reflects time value, however, not all reflections of time value are "interest" for purposes of Section 163.[4]

The essential relationship between an employer and an employee with whom it enters into a deferred compensation agreement remains that of employer and employee; it does not become that of borrower and lender. All amounts that the employee agrees to receive in the future—in exchange for services to be

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[4] See, *e.g.*, *Garvey, Inc.* v. *United States*, 726 F.2d 1569, 1574 (Fed. Cir.) (purchase of property in exchange for private annuity was a capital expenditure, and time-value component of annuity was not deductible "interest"), cert. denied, 469 U.S. 823 (1984); *Autenreith* v. *Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940); *Estate of Arbury* v. *Commissioner*, 93 T.C. 136, 141 (1989); see also *Bell* v. *Commissioner*, 76 T.C. 232, 237 (1981).

rendered after the date of the agreement—are therefore properly and accurately characterized as compensation for those services, no matter when paid or how denominated in the agreement. Moreover, while the additional amounts under petitioner's agreements were computed on the basis of stated interest rates, similar agreements may reflect "time value" through adjustments based on, for example, the consumer price index, an index of stock or bond market returns, returns on the employer's own stock, or returns on the actual investment of the deferred payments. See Bittker & Lokken ¶ 60.2.1, at 60-11. Petitioner's theory would presumably require that all such amounts be treated as "interest" for purposes of Section 163. That result is not an obvious interpretation of the statutory language. Compare Pet. 15-16.

Nor is it obvious on what "indebtedness" petitioner would be paying "interest," under its theory, for purposes of Section 163(a). Certainly this case does not involve any borrowing by petitioner, or any loan by its employees, in the ordinary sense of those terms. Cf. *Old Colony R.R.* v. *Commissioner*, 284 U.S. 552, 561 (1932) ("We cannot believe that Congress used the word ['interest'] having in mind any concept other than the usual, ordinary and everyday meaning of the term."). In its first opinion, the court of appeals treated petitioner's contractual obligation to make payments under the deferred compensation agreements as, in itself, "indebtedness" for these purposes. Pet. App. 32a. The court reached that conclusion, however, by applying a general

definition taken out of context.[5] And while "an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of" Section 163(a). *Deputy* v. *du Pont*, 308 U.S. 488, 497 (1940).

The Code does treat some contractual obligations as including an implicit time-value component that must be given separate effect for tax purposes. And, as some of the opinions below point out (see Pet. App. 30a n.14, 61a, 65a n.4), Congress has in recent years required taxpayers to identify and account for such "hidden" or "implicit" interest in a variety of situations. Even in cases (unlike this one) involving transactions that clearly involve "indebtedness," however, it has generally done so by enacting specific and often

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[5] The court cited (Pet. App. 32a) the statement in *Horn* v. *Commissioner*, 90 T.C. 908, 938 (1988), that "[i]ndebtedness has been defined as 'an unconditional legally enforceable obligation for the payment of money.'" *Horn*, in turn, was quoting *Autenreith* v. *Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940), and cited *Knetsch* v. *United States*, 364 U.S. 361 (1960). *Horn* rejected the validity, for tax purposes, of sham "promissory notes" signed by investors in an abusive tax shelter scheme. See 90 T.C. at 938-940. *Autenreith* refused to recognize as "indebtedness" for purposes of Section 163 the obligation (unconditional and presumably enforceable) of three sons to make annual "interest" payments to their mother, on the ground that the payments were actually principal payments for partnership interests acquired from their father after his death. See 115 F.2d at 858. *Autenreith* relied on *Commissioner* v. *Park*, 113 F.2d 352 (3d Cir. 1940), which held, unremarkably, that an interest-bearing demand note was "indebtedness" within "the ordinary meaning of the word." And *Knetsch* refused to recognize, for tax purposes, the "interest" paid on "loans" that were part of a structured tax-shelter transaction. See 364 U.S. at 364-366. None of those decisions has much to do with the situation at issue in this case.

technically complex provisions. See, *e.g.*, 26 U.S.C. 467 (leases with deferred payment provisions), 483 (certain amounts under deferred-payment sales contracts are to be "treated as interest"), 1271-1275 (1988 & Supp. V 1993) ("original issue discount" on debt instruments, including those issued in consideration for the sale or exchange of property), 7872 (loans with below-market interest rates); see also 26 U.S.C. 163(e) (1988 & Supp V 1993) (coordinating interest deduction and original issue discount rules). In the absence of such a provision applicable to deferred compensation agreements, there is no reason to stretch the normal meaning of the statutory terms "interest" and "indebtedness" to include any part of the compensation promised under petitioner's agreements. See, *e.g.*, *Deputy* v. *du Pont*, 308 U.S. at 493 (deductions are to be allowed only as clearly provided by law).[6]

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[6] If petitioner was concerned with the deductibility of any "time value" component of its deferred payments, it could have structured its affairs differently to ensure that result. Had petitioner paid compensation to its executives and then borrowed it back (see, *e.g.*, Pet. 15), or paid its employees with a non-forfeitable promissory note with terms similar to those of the deferred compensation agreements, then its interest deductions would not be in doubt. Of course, either of those arrangements would presumably have required the employees to recognize current income, which would have made the arrangement less attractive to them. See Treas. Reg. § 1.61-2(d)(4); see also Pet. App. 51a n.7. Petitioner used deferred compensation agreements in order to avoid current taxation of its employees. Having selected a particular form for its transaction, petitioner is bound by that form's collateral tax consequences, *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-149 (1974), which in this case include an equivalent deferral of its own deductions. As

We do not contend that the amounts in question in this case could not be viewed as "interest" on "indebtedness" under any circumstances or for any purpose. The question in this case is only whether such a characterization is appropriate for purposes of the deduction provided by Section 163 of the Code. Compare *NationsBank of North Carolina, N.A.* v. *Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 816 (1995); cf. *Clayton* v. *United States*, No. 92-712T (Ct. Fed. Cl. June 30, 1995) (payments from qualified trust are not "compensation" for purposes of certain source-of-income rules applicable to non-U.S. taxpayers) (*reprinted in* 1995 Daily Tax Rptr. (BNA) No. 131, at K11, K22-K23 (July 10, 1995)). Having considered the matter in light of the purposes of that Section and the nature of petitioner's deferred compensation agree-ments, the Commissioner of Internal Revenue has concluded (as did a majority of the Tax Court, Pet. App. 47a-59a) that all payments under those agreements should be treated as "compensation" for purposes of Section 404, and that no part should be treated as "interest" for purposes of Section 163. That contextual interpretation is plainly reasonable, and it is entitled to deference from the courts. See, *e.g.*, *NationsBank of North Carolina*, 115 S. Ct. at 816; *Good Samaritan Hosp.* v. *Shalala*, 113 S. Ct. 2151, 2161-2162 (1993).

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petitioner acknowledges (Pet. 4), for several years it adopted exactly that approach to its obligations under the agreements in question. In that light, petitioner's contention that the decision below "disappointed many taxpayers' settled expectations" (Pet. 20) would appear not to apply, in any event, to petitioner itself.

c. Both courts below also recognized (Pet. App. 7a-19a, 53a-63a) that, whether or not the "further sum[s]" computed under petitioner's deferred compensation agreements could be viewed as "interest" for purposes of Section 163, the recognition of immediate deductions as those amounts accrued would be inconsistent with the terms and purpose of Section 404 of the Code.

Petitioner's deferred compensation agreements constituted a nonqualified, unfunded deferred compensation plan benefitting only eight high-ranking executives and one outside director. As discussed above (see pp. 11-12, *supra*), the nature of the relationship between an employer and an employee is one of payment for services performed, whether that payment is made currently, or deferred under an express agreement entered into before the relevant services are performed. Whether the amount to be paid is adjusted for the delay by using an interest rate, returns on the employer's stock, a cost-of-living factor, a stock or bond index, or some other factor, the employee has not in fact invested in the employer's stock or bonds, or in some informal investment fund. The essence of the relationship remains future compensation for past services, and all amounts payable under the agreement are therefore "compensation" for purposes of Section 404. And Section 404(a)(5) prohibits deductions for any such "compensation" under a non-qualified plan until the amount is actually paid to the participant and includible in his income.

Section 404 has its origins in Section 162(b) of the Revenue Act of 1942, ch. 619, 56 Stat. 863 (codified at 26 U.S.C. 23(p) (1946)). See Pet. App. 10a. In enacting Section 23(p), Congress expressed its intention that

an employer's deductions be matched in time with a participant's receipt of income:

> If an employer on the accrual basis defers paying any compensation to the employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he *will not be allowed a deduction* until the year in which the compensation is paid.

H.R. Rep. No. 2333, 77th Cong., 2d Sess. 106 (1942) (emphasis added); S. Rep. No. 1631, 77th Cong., 2d Sess. 141 (1942). As the court of appeals recognized (Pet. App. 11a-12a), that "matching" principle has been widely acknowledged as "the key to section 404." See, *e.g.*, Bittker & Lokken ¶ 60.1, at 60-2 ("The most consistent feature of the rules for nonqualified plans is that the employer is ordinarily allowed no deduction for contributions, payments, or benefits until they are taxed to the employee.").

Petitioner argues (Pet. 18-19) that because the version of Section 404(a) in effect in the year in question (see Pet. App. 95a) explicitly prohibited only deductions under Sections 162 (relating to business expenses) or 212 (relating to other investment expenses), Congress could not have intended to bar deductions for interest expenses under Section 163. As noted above, however, before Section 404's precursor was enacted in 1942, accrual-basis employers deducted deferred compensation, in advance of actual payment, "as an ordinary and necessary business expense." Pet. App. 55a. There is no indication that Congress at the time thought of such payments, either when accrued or when actually made, as

including any time-value component that could be separated out analytically and treated as "interest" for purposes of tax deductibility. Compare *Old Colony R.R.* v. *Commissioner*, 284 U.S. at 560-561 ("[W]e think that in the common understanding 'interest' means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon, and that the words of the statute permit the deduction of that sum, and do not refer to some esoteric concept derived from subtle and theoretic analysis."). Because Congress had no reason to believe that an employer's obligation to make deferred compensation payments might be deductible under any Code provision other than Section 162 or 212, it is not surprising that Section 404 at first explicitly addressed only deductions under those two provisions.

In 1986—at a time when it had become thoroughly familiar with the concept of implicit interest in the tax context—Congress amended Section 404 to replace the specific references to Sections 162 and 212 with a general reference to deductions "under this chapter" (that is, Code Sections 1-1399). See Pet. App. 96a. The change was made retroactive to 1984, and treated as a technical and clarifying amendment:

> The bill clarifies that the deduction-timing rules for deferred compensation arrangements apply to any plan or method of deferring compensation *regardless of the section under which the amounts might otherwise be deductible* and that the amounts shall be deductible under section 404(a)(5) and *shall not otherwise be deductible under any other section.*

S. Rep. No. 313, 99th Cong., 2d Sess. 1013 (1986) (emphasis added). Thus, when Congress has had occasion to focus on the question, it has made clear that all amounts payable under deferred compensation agreements are to be treated as compensation, and deducted and included by employer and employee at the same time.[7]

Finally, as the court of appeals emphasized (*e.g.*, Pet. App. 13a-16a), allowing petitioner a current deduction for "further sum[s]" accrued under its deferral agreements would undermine the comprehensive scheme that Congress has established to encourage employers to establish and maintain "qualified" plans. The benefits and burdens of qualified plans are carefully calibrated. See pp. 9-10, *supra*; Pet. App. 9a-10a, 13a-15a. Recognition of petitioner's claimed deduction would upset that calibration. As the court of appeals put it, if an employer "could simply retain the funds and receive tax benefits similar to those [it] would receive if those amounts were paid out, there

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[7] Similarly, the explicit reference in Section 457(a) to "income attributable" to amounts deferred under a state or local government's deferred compensation plan (see Pet. 18) merely reflects increased analytical sensitivity to implicit interest issues on the part of the drafters who revised that Section in 1986. Petitioner's reliance (Pet. 22) on Section 467(g) of the present Code, first enacted in 1984, is similarly misplaced; that Section does not apply to "any amount to which section 404 * * * applies." And the fact that Section 267 of the Code prohibits a variety of schemes that would otherwise result, like the analysis of deferred compensation that petitioner urges, in the mismatching of deductions and income in transactions between certain related taxpayers (see Pet. 22) sheds little light on the proper interpretation of Section 404's specific rules regarding all deferred compensation agreements.

would clearly be little incentive to establish a qualified plan." Pet. App. 10a.

Depending on the deferral period and the rate used to calculate additional amounts under a deferred compensation agreement, the "additional" amounts due under such an agreement could, as the court of appeals recognized (Pet. App. 14a), easily exceed the original "basic" amount an employee agreed to defer. The court correctly reasoned that Congress could not have intended to prohibit an employer that maintains a nonqualified deferred compensation plan from deducting the basic amount before actual payment, but to allow a current deduction for what might well be the bulk of the package. *Id.* at 14a-15a. Moreover, because an employer with a qualified plan could deduct only the "basic" amounts actually contributed to a trust for the benefit of plan participants, allowing current deductions for "additional amounts" under nonqualified plans could actually encourage the establishment of nonqualified plans in preference to qualified ones. There is no warrant for rejecting the Commissioner's reasonable construction of the term "compensation" in Section 404, in favor of a theoretical construct that would have the effect of providing similar or even greater tax benefits to a nonqualified plan that discriminates in favor of a few highly compensated individuals and does not require current funding or separate administration to secure the future availability of any part of the benefits promised under the plan.

d. As petitioner acknowledges (Pet. 23), there is no conflict among the courts of appeals about the nondeductibility of any amount payable under a deferred compensation agreement. Indeed, this case appears to be the first one to address the question. Had the

court of appeals accepted petitioner's novel argument, other taxpayers would undoubtedly have attempted to claim similar deductions. The dramatic fiscal implications of that departure from the status quo would have made the decision one of exceptional importance, and might have warranted review even in the absence of a conflict. See generally Pet. App. 100a-102a (government's petition for rehearing below). Because the court of appeals ultimately reached the correct decision, however, its judgment preserves, rather than upsets, the reasonable expectations of both Congress and taxpayers, and threatens no unwarranted depletion of the fisc. Moreover, the retroactive amendment to Section 404 discussed above forecloses petitioner's contention for all taxable years after 1984, and the issue is therefore of limited continuing importance. Under the circumstances, there is no reason for this Court to review the case.

2. a. Section 38 of the Code, as in effect during the taxable year at issue, allowed a credit against tax for a portion of a taxpayer's investment in certain types of "section 38 property." The definition of "section 38 property" included "tangible personal property (other than an air conditioning or heating unit)." 26 U.S.C. 48(a)(1)(A) (1982). Treasury regulations in turn defined "tangible personal property" to include all tangible property except land, buildings and other inherently permanent improvements, and the "structural components" of buildings and similar structures. Treas. Reg. § 1.48-1(c) (1982). The regulations further defined "structural components" to include "all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system. " Treas. Reg. § 1.48-1(e)(2) (1982).

Petitioner nonetheless claims (Pet. 23-26) that it is eligible for the investment tax credit with respect to HVAC systems installed in its grocery stores during the tax year at issue in this case. Petitioner relies entirely (see Pet. 23) on an exception set out in Section 1.48-1(e)(2) of the regulations (*reprinted at* Pet. App. 98a-99a), which provides:

> [T]he term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components."

The government has never disputed that the HVAC systems at issue here provided the temperature and humidity necessary for the proper operation of the refrigerated food cases in petitioner's stores. The dispute has centered instead on whether that effect could plausibly have been the "*sole* justification" for installation of those systems in petitioner's retail food stores. The court of appeals correctly held (Pet.

App. 37a-40a) that it could not. As the court pointed out (*id.* at 38a), the HVAC systems played an important role in the essential function of ventilating the supermarkets. In addition, as the court recognized (*id.* at 38a-39a), air conditioning in the summer and heating in the winter provided a comfortable year-round shopping environment for petitioner's customers. It is therefore hardly surprising that, as the court observed (*id.* at 39a), petitioner had installed HVAC systems in most of its stores during the 1950s, well before it was aware of any relationship between those systems and the proper operation of its display cases.

The court of appeals properly concluded that, while maintaining the proper temperature and humidity to operate other equipment might have been one reason for installing HVAC systems, it was not the "sole justification" for installing them within the meaning of the regulations. Pet. App. 40a. Whatever the precise contours of the "sole justification" test, a particular justification cannot be the "sole" one if the HVAC system in question would have been installed in any case, even if that justification had somehow been eliminated.[8] In this case, it is abundantly clear

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[8] The regulations provide that an HVAC system may meet the "sole justification" test even if it "incidentally provides for the comfort of employees." Pet. App. 98a. As the court pointed out (*id.* at 39a-40a), the example given to illustrate that point is a narrow one, involving maintenance of a temperature and humidity range "critical" to the production process in a factory. *Id.* at 98a-99a. The example implies that if the system were not required for the manufacturing process, the taxpayer would not have installed it in any event, simply for the benefit of the factory's employees. The same cannot plausibly be said of an HVAC system that maintains, among other functions, an

that petitioner would have installed air conditioning and heating systems in its retail stores—located from Florida to Idaho—in order to ensure proper ventilation and a comfortable customer environment, *whether or not* those systems were necessary to the operation of any other equipment in its stores. "That is, indeed, little more than common sense." Pet. 24.[9] The decision below is plainly correct, and there is no need to revisit it in this Court.

b. Petitioner argues (Pet. 13-14, 26) that the court of appeals' decision on the investment tax credit issue conflicts with the decision in *Piggly Wiggly Southern, Inc.* v. *Commissioner*, 803 F.2d 1572 (11th Cir. 1986). In *Piggly Wiggly*, the court held that "[t]he 'sole justification' test necessarily involves a factual determination as to why the taxpayer made particular expenditures." *Id.* at 1576. The court refused to "say as a matter of law that a supermarket's sole justification for installing a particular HVAC system could not have been to meet temperature and humidity needs of other equipment." *Ibid.* On the

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attractive and comfortable environment for retail grocery store customers.

[9] Petitioner argues (Pet. 5-6, 23-24, 25-26) that it keeps the temperature in its stores lower than it otherwise would during the summer because of the requirements of its display cases. Even if those requirements provide the "sole justification" for the thermostat setting that petitioner chooses, however, that does not demonstrate that they provide the "sole justification" for having heat or air conditioning in the first place. When the outdoor temperature is over 90 degrees, petitioner's customers might prefer that the indoor temperature be maintained at 78 degrees rather than at 72 degrees, see Pet. App. 74a; but it is difficult to believe that they would prefer (or even tolerate) the absence of any air conditioning at all.

facts of the case before it, the court held that there were "two permissible views of the evidence," and refused to characterize as "clearly erroneous" the Tax Court's "factual findings * * * that Piggly Wiggly chose the particular HVAC system [involved in that case] in order to meet equipment specifications and that customer and worker comfort was an incidental benefit." *Id.* at 1575, 1576.

In this case, applying the same legal standard to similar facts, the court of appeals reached a different factual conclusion. Pet. App. 38a-40a & n.25. One other court has reached the same result as the court below, after an exhaustive examination of the particular facts of the case before it. *Publix Supermarkets, Inc.* v. *United States*, 26 Cl. Ct. 161 (1992). Whatever the merits of *Piggly Wiggly*'s holding on the facts of that case, there is no conflict among the courts on the applicable legal standard; and any variations in the ultimate factual determinations reached in the few cases that have addressed the "sole justification" issue in the supermarket HVAC context do not warrant review by this Court.

Moreover, as petitioner acknowledges (Pet. 14), the investment tax credit was repealed, with limited transitional exceptions, by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2166-2170. The repeal of the credit considerably diminishes the importance of the "sole justification" test at issue in this case. As petitioner points out (Pet. 14), the test remains relevant for purposes of determining the availability of certain accelerated depreciation deductions. If it becomes necessary for this Court to consider the meaning or application of the test for those purposes, however, it would surely be preferable to await a case that presents specific issues of

continuing relevance in an appropriate legal and factual context.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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